THE WORKING POOR AND SOCIAL SECURITY PRIVATIZATION
Restoring the Opportunity to Save

by Carrie Lips

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Executive Summary

Many defenders of Social Security assert that the program favors the poor and keeps low-wage earners out of poverty. Those claims are mistaken.

Today, despite Social Security's progressive benefit structure, more than 1 in 10 seniors live in poverty. Social Security simply costs too much and pays too little. The rate of return on Social Security taxes paid during a working life is dismal, making the opportunity cost of participating in the program instead of a private retirement plan tremendous. Social Security's approaching fiscal crisis threatens to make this situation worse.

The poor would accrue substantial savings and enjoy much larger retirement benefits if they were allowed to redirect payroll taxes to individually owned, privately invested accounts. Instead of relying on political promises for retirement security, low-wage workers would have tangible retirement savings built from their earnings. Such a system would provide greater financial security and would go a long way toward eliminating poverty among the elderly.

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Introduction

Since President Clinton moved Social Security to the forefront of political debate with his state of the union call to "save Social Security first," a bipartisan consensus has been building that Social Security needs to be reformed to incorporate private investment. However, defenders of the status quo trot out the plight of the elderly poor, who are often entirely dependent on Social Security for retirement income, as a primary reason that Social Security's structure should not be changed. But that is one of the primary reasons that Social Security must be changed.

The poor would benefit most from transforming today's Social Security system into one based on individual savings. Currently, Social Security's high payroll taxes buy workers only the hope that the government will be able to extract enough taxes from the next generation of workers to pay legislated benefits. Those promised benefits are meager and represent a below-market rate of return. Even worse, in the near future, the government will be unable to meet its obligations and will have the choice of cutting benefits by 25 percent, raising taxes, or increasing the federal debt.

By allowing workers to redirect their payroll taxes to individually owned, privately invested accounts, the government would give individuals the opportunity to prefund their future retirement benefits. Through the power of compound interest, all workers would be able to accrue by retirement a substantial asset that would provide benefits significantly greater than those promised by Social Security today. That is particularly important to low-wage workers who depend on such a stream of income for retirement security.

Additional benefits of private accounts for the poor are numerous: the accounts would be private property that individuals could pass on to their heirs at death; the increased savings rate would cause the economy to grow, creating more jobs; and, instead of being beholden to the government for a monthly retirement check, the poor would be self-sufficient, providing for themselves a better retirement than that promised by Social Security.

Carrie Lips is project assistant for the Cato Project on Social Security Privatization.

All workers--but particularly low-wage workers--need and deserve the opportunity to participate in a retirement system that makes the most of their contributions and gives them ownership of their retirement income.

Does Social Security Really Help the Poor?

The people who created the Social Security program intended to provide a safety net against poverty during old age. The first question to address when evaluating Social Security is whether or not the program has adequately fulfilled its mission.

The elderly community's poverty rates reveal that Social Security has failed to provide retirement security for all seniors. Today, despite Social Security's intergenerational wealth transfer system that consumes 22 percent of the federal budget, 11 percent of the elderly remain in poverty.[1] For some groups, the statistics are even worse: 19 percent of widows[2] and 29 percent of elderly African-Americans[3] have fallen through Social Security's so-called safety net and live in poverty.

Social Security's benefits are simply not enough. Most financial planners believe that, in order to maintain a pre-retirement standard of living, retirees need between 60 and 85 percent of preretirement income.[4] Social Security provides low-wage workers with a benefit equal to approximately 58 percent of their preretirement income.[5] Those elderly who depend entirely on Social Security and receive just 58 percent of their preretirement income often fall below the poverty threshold.

Proponents of the status quo frequently cite Social Security's progressive benefit structure as evidence that the system favors the poor. It is true that the benefit formula is designed to be progressive: average workers get back approximately 43 percent of their preretirement income; high-wage workers get only 25 percent.[6] However, according to studies by the RAND Corporation and the Heritage Foundation, Social Security's progressivity may be completely eliminated and, in some cases, even reversed by differences in longevity.[7]

That is because the amount of money received from Social Security depends on how long an individual lives. Individuals with lower incomes tend to die younger and, therefore, collect fewer Social Security checks than those in higher income brackets. For example, on average, a white man in the highest income bracket who reaches age 65 will live 3.1 years longer than a white man in the lowest income bracket. Three years amounts to 36 additional checks from the Social Security Administration. Similarly, high-income black males live 2.5 years longer than do those in the lowest income group.[8] Although the poor may receive a larger percentage of their preretirement income each month, they generally receive fewer payments.

In addition, the poor tend to start working earlier than high-income workers because they are less likely to attend college or graduate school.[9] Thus, many low-income workers work 45 years or more, but, because Social Security's benefits are based on only 35 years of earnings, the extra years are uncompensated.

Those factors disproportionately affect certain demographic groups, particularly African-Americans. The average life expectancy of a black male born today is just 66.1 years. When a black male reaches age 65, he is expected to live only another 13.9 years, almost 2 years--24 payments--less than a white male.[10] According to a study conducted by the RAND Corporation, differences in life expectancies and marriage rates result in a net income transfer through Social Security from blacks to whites of as much as $10,000 per person on a lifetime basis.[11]

The good intentions of the people who designed Social Security do not change the reality that the program often fails to help those elderly most in need. The failure of this massive federal entitlement program to provide retirement security for 1 in 10 elderly people is reason enough to examine the program's structure in an effort to improve the lot of the elderly who are in poverty today.

The Cost of Social Security

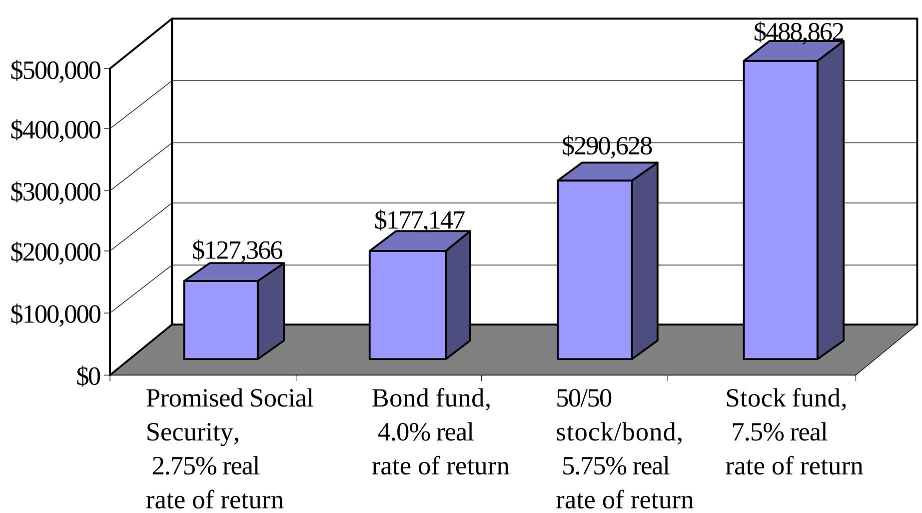
Defenders of the current program point to how much worse off many elderly people would be without Social Security's benefits. Indeed, according to the Social Security Administration, two-thirds of beneficiaries depend on Social Security for more than half of their retirement income and 30 percent rely on Social Security for more than 90 percent of their retirement income.[12]

However, the benefits the poor receive in retirement should be evaluated in relation to the program's cost for low-wage workers. For low-wage workers, the opportunity cost of forfeiting 12.4 percent of income to the government is tremendous. That is money that could have been used for education, housing, a private savings plan, or other important needs. Therefore, the relevant question when evaluating Social Security is whether or not the benefits received in retirement justify the taxes paid to support the system.

Today, a 28-year-old worker making $13,500 per year pays $1,674 in payroll taxes (including both the employer and employee share of the tax). In return for his lifetime of contributions, the Social Security Administration promises to give him a payment equal to $815 per month in today's dollars when he retires at age 67. That represents a rate of return of just 2.75 percent, well below the return one could expect from a private savings plan. Social Security's cost to the worker can be viewed as the forgone wealth that would have accrued in another retirement plan.

Had this low-wage worker participated in a conservative savings program that invested in bonds and earned just a 4 percent rate of return (which is approximately the historic average return for corporate bonds),[13] his monthly payment in retirement would be $1,243, more than $400 greater than Social Security's benefits. The difference in value of those two streams of payment--the amount lost by paying into Social Security--is almost $50,000.

Figure 1
Value of Retirement Plan for a Worker Born in 1970 Who Has a Salary of $13,500 and Retires at Age 67



Source: Cato Institute's calculator at www.socialsecurity.org.

If you compare Social Security with a more typical savings plan that earns a 5.75 percent return on a mix of stocks (which historically have provided a return of 7.6 percent)[14] and bonds, the amount lost by participating in Social Security is more than $150,000. The difference between Social Security and an all-stock fund is more than $350,000 (see Figure 1).

Workers recognize the incredible loss they sustain because they are unable to save and participate in the market. A recent article in the Washington Post highlighted the feeling of disenfranchisement experienced by workers who, after paying taxes and providing for basic living expenses, simply are unable to accumulate savings and participate in the market:

> One of the many standing on the sidelines is Mike Marcus, a 45-year-old painter from Summit Point, W.Va. "Pfft. Don't care," he shrugged, when asked his views about the Dow Jones industrial average's giddy climb to the 9000 level. "You've got to have money to get into it. If you live paycheck to paycheck, it's kind of hard to do that."
>
> Analysts at the Vanguard Group estimate that if Marcus had managed to squirrel away $1,000 each year after his 20th birthday, plowed that money into a mutual fund that matched the performance of the Dow and reinvested his dividends, he would now own a stock portfolio worth more than $332,433.[15]

The trouble is that low-wage workers do not have an extra $1,000 to "plow into a mutual fund." The money they are forced to contribute to the federal government's retirement plan is often the only money they could invest in a true savings program. The abysmal rate of return provided by Social Security not only translates into meager benefits that leave many in poverty but also represents a tremendous lost opportunity to accumulate substantial savings.

Social Security's Fiscal Future

Social Security will soon be facing a fiscal crisis as payroll taxes become insufficient to pay legislated benefits. Without Social Security reform, the federal government will have to cut benefits, increase taxes, or enlarge the debt. Any of those options makes Social Security's rate of return worse and has dire consequences for low-wage workers.

Social Security's problems--meager benefits, dismal rate of return, and approaching deficits--are the inevitable consequences of its flawed system of financing. In a typical retirement plan, money is invested in companies that provide services and products consumers want. When a company succeeds, more wealth is created and the assets in the individual's retirement account become more valuable. Social Security's pay-as-you-go financing is the exact opposite of that of a typical pension plan. Money taken from workers is immediately redistributed to beneficiaries for consumption. Nothing is saved toward the future benefits to be paid to today's workers. Instead of increasing the supply of wealth through investment, Social Security decreases investment in order to meet the demand for disposable income for seniors. Instead of having an asset built from their contributions, today's workers retire with only a political claim on future tax revenue.

Because of changes in demographics--increased life expectancies and lower birthrates--the government will find it increasingly difficult to extract enough taxes from the next generation of workers to pay the benefits it has promised. In 2013 Social Security will pay out more in benefits than it will collect in payroll taxes. The government will have to use general tax revenue to reimburse Social Security's trust fund in order to meet its obligations to seniors. When the trust fund has been exhausted in 2032, payroll taxes are projected to be sufficient to fund just 75 percent of promised benefits.[16] For the poor who have contributed all of their lives and have no other retirement savings, such benefit cuts would be devastating.

To avoid cutting benefits, the government could raise taxes. In order to make Social Security solvent in 2032, today's 12.4 percent payroll tax would have to be increased by nearly 50 percent, forcing tomorrow's workers to give up nearly one-fifth of their income just to pay for Social Security.[17] Three-fourths of all Americans already pay more in payroll tax than they do in federal income tax.[18] The additional tax burden would leave tomorrow's low-wage workers with even less disposable income, decreasing their chance to save and leaving them even more dependent on the federal government's crumbling retirement program.

The Benefits of Personal Retirement Accounts

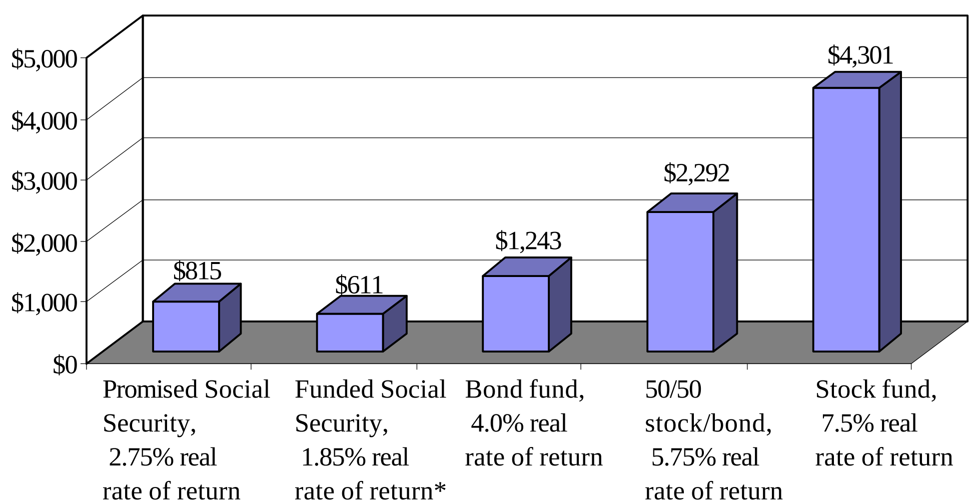
By reforming Social Security to allow workers to redirect their payroll taxes to individually owned, privately invested accounts, the government would give individuals the chance to prefund their future retirement benefits and accrue substantial savings by taking advantage of markets. The benefits of a system of personal retirement accounts are numerous:

Higher Retirement Benefits, Less Poverty

All workers would receive higher retirement benefits under a system that gave them the ability to invest their contributions in productive enterprises. Throughout a worker's lifetime, his contributions would accumulate and earn interest in an account. At retirement, his asset would be able to provide a much higher monthly benefit than would Social Security.

For example, if the 28-year-old worker who made $13,500 invested his payroll taxes throughout his lifetime,

Figure 2
Monthly Benefits for a Worker Born in 1970 Who Has a Salary of $13,500



*When this worker retires, the Social Security Administration projects that it will be able to pay only 75 percent of currently legislated benefits.

Source: Cato Institute's calculator at www.socialsecurity.org.

he would accrue $290,628 by age 67,[19] assuming that he invested in a mixed fund of 50 percent bonds and 50 percent stocks and received returns of 4 percent and 7.5 percent, respectively. With those funds, he would be able to purchase an annuity that would provide a stream of monthly payments of $2,292--almost three times the benefit currently promised (but not yet funded) by Social Security (see Figure 2).

Such additional revenue would have a significant impact on the standard of living of low-wage workers, who typically depend on Social Security for the bulk of their retirement income.

Private Property

Each individual's personal retirement account would be private property, which could be passed on to his heirs at death.

Today, a single mother could work and contribute to Social Security her whole life, and if she died at 64, Social Security would give her nothing to pass on to her children. With personal retirement accounts, the same woman, born in 1960, making $15,000 a year throughout her lifetime, would, by the time she was 64, accumulate $300,000 in a balanced fund that could be left to her descendants.[20] That nest egg would be particularly meaningful to families who are now typically unable to leave an inheritance to the next generation and would go a long way toward breaking the cycle of poverty.

Moreover, personal retirement accounts are simply fair: workers deserve to own the products of their labor. As previously discussed, low-wage workers tend to die earlier than do those in higher income groups. Giving individuals property rights to their contributions would eliminate the correlation between return on investment and life span.

Individual Empowerment

In the current system, the retired poor are beholden to the federal government for a monthly retirement check and face considerable political risk. As the Supreme Court reminded us in the Fleming v. Nestor decision in 1960, individuals do not have a "right" to Social Security benefits based on contributions.[21] At any time, politicians can reduce or even eliminate benefits. In fact, Social Security taxes have been raised more than 30 times since the program began.[22] With Social Security's financial prospects becoming increasingly grim, the risk that politicians will cut seniors' benefits is very real.

A system of personal retirement accounts would end the dependence of the elderly on the federal government and allow them to retire with greater benefits and the pride of having provided for their own retirement security. Instead of having 12.4 percent of earnings disappear in the black hole of the federal government, workers would see their contributions accumulate in accounts and grow throughout their working lives.

Essentially, a system of personal retirement accounts would be an employee stock option plan for America. All workers would be vested in the U.S. economy and would have a tangible incentive to be productive participants in the workplace. That would be particularly important to workers who struggle paycheck to paycheck and have no income available for savings. Instead of feeling left out of the economy, all workers would have an interest in the country's economic success. They would be encouraged to continue working and savings by seeing wealth accumulating in their accounts.

Effects on the Economy

Unlike a traditional retirement savings plan, today's Social Security program reduces savings by immediately redistributing workers' contributions for consumption. The reduced savings rate means there is less investment capital available for new businesses and economic expansion.

That drain on the economy affects the poor in several ways. The lack of capital slows and sometimes eliminates investment in poorer areas that might otherwise be seen by investors as opportunities for growth. Less capital is available to businesses for expanding, conducting more research, creating more jobs, and making better products for consumers.

Economist Martin Feldstein estimates that, as a result of moving to a system of personal retirement accounts, the gross domestic product would increase by 5 percent permanently and the net present value to the economy would be a gain of $10 trillion to $20 trillion.[23] For the poor, those macroeconomic trends would translate into the creation of new businesses in their communities; more jobs; and better, cheaper products.

Is Privatization Too Risky?

Critics of privatization often concede that a system of personal retirement accounts would lead to greater wealth creation. However, they believe such a system is somehow riskier than the current program's unfunded political promise. The poor, they argue, are not educated enough to make wise investment decisions, and privatization is tantamount to gambling with their future.

A student of the financial markets would point to the relatively stable gains the stock market has generated historically over long investment periods as evidence that private investment is not inherently risky.[24] Moreover, a system of personal retirement accounts could easily incorporate provisions that would alleviate such concerns and ensure that the original goals of the program were met:

- The government could provide a safety net financed out of general revenues to ensure a minimum benefit at retirement.

- The government could approve broad investment alternatives to guard against speculation and overly risky investments.

- Individuals could be given the option of remaining in the current Social Security program.

Such provisions have been successfully used in countries that have privatized their public pension systems and could easily be incorporated into a program in the United States.[25]

Any discussion of the risks of privatization must also acknowledge the risks of staying with the current system. With the program underfunded by $9 trillion, retirees face the risk that their benefits will be cut and workers face the risk that their taxes will be increased. The Social Security Administration projects that by 2032 it will be able to pay only three-quarters of legislated benefits; there may not be just a "risk" that Social Security will be unable to keep its promises, it may be inevitable.

An important distinction between the current Social Security program and a privatized system is that, unlike in today's system, individuals with a personal retirement account would be able to control the level of risk they assumed. A risk-averse individual could choose to purchase only bonds with a guaranteed return. The risk of today's Social Security program is unavoidable.

Conclusion

Today's Social Security program, in large measure, fails to meet the goals set for it. Too many of today's elderly remain in poverty, and far too many are dependent on the government's ability to tax future workers for their retirement security. Pay-as-you-go financing is anathema to real savings and wealth creation. For low-wage workers who often cannot afford a second retirement plan, the lost opportunity to save and invest the money taken as payroll taxes is irrevocable and devastating.

A system of personal retirement accounts would truly meet the goals of the people who created the Social Security system. Through investment, low-wage workers would be able to accrue a substantial asset and enjoy higher benefits during retirement. Instead of a crushing tax burden being imposed on the next generation, all individuals would have the opportunity to pass on an inheritance to their heirs. Instead of being beholden to the government for a monthly check, all elderly persons would be self-sufficient, providing for themselves a better retirement than that promised by today's Social Security.

Notes

1. U.S. House of Representatives, Committee on Ways and Means, 1998 Green Book (Washington: Government Printing Office, 1998), p. 1037.

2. Ibid.

3. Social Security Administration, Fast Facts and Figures about Social Security, 1997 (Washington: Government Printing Office, 1997), p. 8.

4. See, for example, A. Haeworth Robertson, Social Security: What Every Taxpayer Should Know (Washington: Retirement Policy Institute, 1992), p. 218.

5. U.S. House of Representatives, 1998 Green Book, p. 27,

Table 1-17.

6. Ibid.

7. W. Constantijn, A. Panis, and Lee Lillard, "Socioeconomic Differentials in the Returns of Social Security," RAND Corporation Working Paper no. 96-05, February 1996; and William Beach and Gareth Davis, "Social Security's Rate of Return," Heritage Center for Data Analysis Report no. 98-01, January 15, 1998.

8. U.S. Department of Health and Human Services, *Health, United States, 1998* (Washington: Government Printing Office, 1998), p. 88.

9. Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998), pp. 99-100.

10. U.S. Department of Health and Human Services, p. 200.

11. Constantijn, Panis, and Lillard, p. 20.

12. Social Security Administration, p. 7.

13. Ferrara and Tanner, p. 73.

14. Melissa Hieger and William Shipman, "Common Objections to a Market-Based System: A Response," Cato Institute Social Security Paper no. 10, July 22, 1997, p. 7.

15. Clay Chandler, "Boom Is Fine--If You Own Stock," *Washington Post*, April 7, 1998, pp. A1, A12.

16. *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, 1998), p. 4.

17. Ibid., p. 108.

18. U.S. House of Representatives, Committee on Ways and Means, "Background Materials on the Federal Budget and Tax Policy for Fiscal Year 1991 and Beyond," February 6, 1990, p. 30.

19. Calculations were preformed on the Cato Institute's calculator at www.socialsecurity.org.

20. The same assumptions were used as were used in the previous calculation.

21. 363 US 603. For information on the implications of Fleming v. Nestor, see Ferrara and Tanner, pp. 27, 92.

22. 1998 Trustees Report, p. 33, Table II.B.1.

23. Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," Cato Institute Social Security Paper no. 7, January 31, 1997; and Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," American Economic Review 86 (May 1996): 1-14.

24. See Hieger and Shipman.

25. For an example of how a fully privatized system could be structured and implemented, see Tanner and Ferrara, chaps. 8, 9.